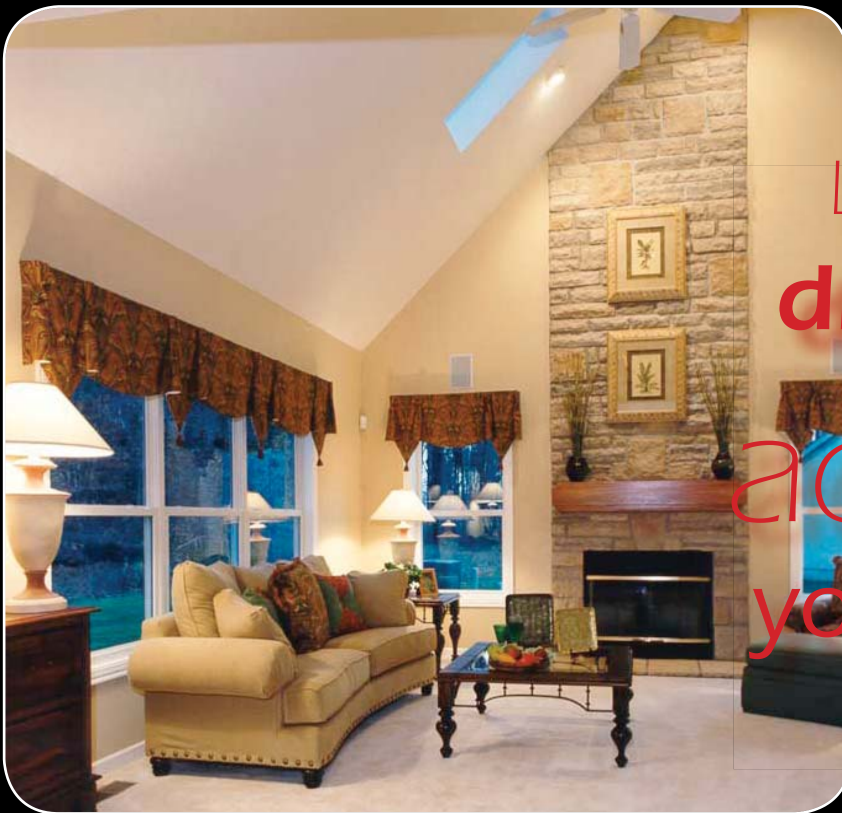
Home Study Program Module 11
Advanced Property Strategies

Wealth Creation Dynamics



Learn how to **drastically** advance **your** financial future.

by Philip Sigglekow

Author of best seller 101 ways to get rich quicker.

Welcome

Module 11
Advanced Property Strategies

Welcome to module 11 of the Wealth Creation Home Dynamics Study Course - Advanced Property Strategies

This module is number 11 of 24.

Each module is presented in the same layout and contains exercises that you can do in your own time.

The benefits of participating in this Home Study Course are:-

- You progress at your own pace.
- You can study in the privacy of your own home.
- You can ask questions regarding the course at questions@apin.com.au

We hope you enjoy the Wealth Creation Home Study Course.

Best regards,
The team at APIN

Contents

Module 11 – Advanced Property Strategies

	Welcome	1
	Contents	2
1	Fortunes are made in Property Property Historical Trends Exercise	3
2	Understanding Property Ways to Invest Types of Property Title Speculators and Investors Exercise	8
3	Your Principal Asset Your Home Using Equity in Your Home Exercise	13
4	More Property Options Commercial and Industrial Leisure and Tourism Other Property Investments Exercise	19
	Final Reflection	26

Property Historical Trends

Until the drop in residential property prices in the late 1980s, it was hardly news to tell you that owning your own home is probably the best single long-term investment you'll ever make.

In addition, many Australians have made substantial fortunes from property investments. But the events of the late 1980s and early 1990s may have made you re-think your attitude to property investments.

Firstly, there was the fall of several property tycoons. You may be thinking "If these 'experts' came crashing down, what hope is there for the individual investor?".

In fact, the property wheeler-dealers who accumulated huge fortunes on paper simply "geared up" with high levels of debt in the hope that prices would keep rising forever. They weren't "experts" at all — just financial jugglers trapped finally by their own excesses.

Their rise and fall says more about the ethos of the 1980s and 1990s as the "decade of greed" than it does about the intrinsic merits of property as an investment.

So, if you're like most people, with a reasonable level of debt, and if you don't have to sell right now — and if you bought a house as a home first and an investment second — the chances are that your money is perfectly safe.

Long-term supply and demand factors — plus the fact that your house is exempt from Capital Gains Tax — means that over time you'll almost certainly do well out of your investment in your home.

Despite what some real estate agents say, property prices move in cycles just like all other investments

Soft prices may be hard on sellers. But they often mean opportunities for buyers. It may well make good sense for you to borrow against your equity in your home to invest in a second or even third property — for income or capital gains, or both.

As you'll see, the world of potential property investment embraces a wide range of opportunities over and above the single family home.

You can choose vacant land, recreational, industrial and commercial property, or indirect property investments, such as shares in property companies listed on the sharemarket, or units in property trusts. Depending on your own goals and objectives, you can pick the type of property investment best suited to your personal situation.

And, for once, governments are at least partly on the side of the personal investor. Planning restrictions are being eased in many areas to increase supply. Also, banks and other lenders are more receptive to applications for loans secured against real estate.

And — best of all — you may find that your interest payments on property investments are tax-deductible.

As with all investing, timing is a key consideration. Property markets, like sharemarkets, are cyclical. Periods of booming prices are followed by stagnant or even falling prices.

But as you'll see, both rising and falling markets provide opportunities for profits for both the long-term investor and the short-term speculator or "dealer".

13 strategies for successful real estate investment

1. Avoid low-cost medium-density housing near a Central Business District (CBD).

2. Ignore anonymous houses in suburbia without features appealing to future occupiers or developers.

3. Consider turning a 'wasted' backyard into rental real estate through a dual-occupancy development.

4. Treat negative gearing with caution. Negative gearing succeeds only if your property rises in value during your ownership. This can be hard to achieve in times of low inflation.

5. Negotiate to buy two home units at the same time at a big discount to the asking price. This is highly effective with slow-selling new developments.

6. Buy adjacent houses on large sites that have future development potential.

7. Try to add value for money in ways such as obtaining development approval for your rental property.

8. If you buy in a suburb chose one with proven long-standing appeal to home-owners.

9. Seek properties with features such as water views, extra large rooms and off-street parking particularly near to a CBD.

10. Target properties that appeal to a market niche, such as elderly people in good health who find the family home too big but want to keep living in the suburbs where they have always lived.
11. Do not buy investment properties from unlicenced marketing companies (ask for copy of licence).
12. Obtain a Quantity Surveyor's Report for new and second hand properties before settlement.
13. Get your accountant or financial adviser to crunch the figures before settlement.

Investing in residential property — what happened

Table 1 outlines what every homeowner knows — the residential property market turned down sharply in the early 1990s — particularly in Sydney. These figures also illustrate that there is no such thing as "the" property market in Australia — there are significant regional differences in the property cycle. House prices may be booming in one suburb while simultaneously being stagnant in another.

As you can see, the sharpest price increases in the late 1980s were also in Sydney, where the boom psychology drove buyers to pay unrealistic prices for fear of being left out of the game. When the shakeout came, many investors were left as distressed sellers squeezed by high interest rates and with no buyers in sight.

In 1993 residential house prices began to pick up in many areas following the fall in mortgage interest rates. House prices continued to move up in 1994 as the economy began to come more positively out of the recession. Home-building activity dropped sharply in 1995, and remained depressed during 1996 — despite low home loan interest rates.

Table-1

Capital City Median House Prices

Year	Sydney	Melbourne	Brisbane	Adelaide	Perth	Canberra
1984	82,000	50,600	55,200	46,300	48,600	59,200
1985	85,800	68,200	58,900	69,000	48,000	84,100
1986	85,100	80,500	61,600	77,200	52,900	91,100
1987	104,400	85,200	59,500	76,500	57,400	91,000
1988	129,300	96,100	64,000	76,800	62,400	90,900
1989	194,900	122,100	79,700	84,100	89,500	106,200
1990	179,000	139,500	105,700	103,500	98,000	118,500
1991	174,800	138,400	108,300	107,400	95,500	125,900
1992	178,900	137,300	120,800	112,100	97,000	154,800
1993	185,800	143,400	124,100	113,400	106,300	159,400
1994	196,000	143,700	130,300	112,300	115,300	160,500
1995	198,700	144,300	133,700	110,000	127,900	155,300
1996	222,000	164,000	136,000	110,400	128,000	150,000
1997	230,000	170,000	140,000	114,900	135,000	155,000
1998	260,000	198,000	144,000	120,300	144,000	160,000
1999	280,000	226,000	145,000	125,000	148,500	158,000
2000	315,000	253,000	149,000	135,000	157,800	184,000
2001	316,000	291,000	180,000	148,200	165,700	203,000
2002	388,000	327,000	230,000	170,000	185,700	227,600
2003	467,000	354,000	270,000	209,100	209,100	292,800
2004	505,000	373,800	302,300	248,800	248,800	361,900

Source: Real Estate Institute of Australia.

How the House Price: Income ratio signalled the collapse of the boom

One key indicator that often warns astute market watchers of an impending crunch in property prices is the House Price:Income ratio. This is simply the relationship between the average house price and average income. For example, if the average house price is $200,000 and the average income for Australians is $40,000 the ratio is five to one.

This ratio has fluctuated somewhat from year to year. But the long-term trend has been surprisingly consistent since the 1950s at around 3.5 : 1 — that is, an average house costs three and a half times the average salary.

Another key indicator is home loan affordability. This is annual family income divided by average annual mortgage loan repayments, multiplied by 10. The higher this figure, the easier it is for people to buy a home.

The home loan affordability figure measures the average persons ability to repay a home loan. The higher this figure, the more people there are who can afford to buy. Inevitably, prices rise.

Housing affordability

One reason why the house price/income ratio has become less credible as an indicator of the housing market is that it takes no account of moves in mortgage interest rates. Interest rates have become much more volatile over the past decade. Clearly, houses of any given price are more “affordable” at an eight per cent interest rate than at a 15 per cent interest rate.

The affordability ratio incorporates no just average house price information, but the cost of taking out an 80 per cent mortgage to buy the house. It shows the proportion of pre-tax average income absorbed by such mortgage payments.

Unfortunately this measure of "affordability" no more rings a bell when the housing market hits a peak or trough than does the more traditional house price/income ratio. A rational person might think that once mortgages started absorbing over 40 per cent of income, as they did in the late 1980s, the bubble must be about to burst.

By including interest rates, the ratio is undoubtedly a better measure than the house price/income ratio of whether house buyers are finding it easier or harder to afford a house.

Remember though the concept is not an entirely new one. In the old days of strictly rationed mortgages and less volatile interest rates, many home lenders considered it imprudent to grant a loan that would absorb more than 25 per cent of the borrower's income.

What makes property prices swing — and the long-term trends

Recent decades have seen a number of property booms followed by periods of stagnant or declining prices. Both in the 1960s and 1970s, as, in the 1950s after the Korean war, demand outstripped supply, only to be followed by a reversal with falling prices and slow markets.

Many experts believe future peaks and troughs in property demand won't be as severe or sustained as in the past. Cycles of good and bad times may be closer together, but not as extreme. In the near term, low levels of inflation may hold back residential property prices. But, in the long-term, the property price trend will be relentlessly upward.

The major long-term trend affecting the upward movement of residential property prices is the steadily increasing number of householders in Australia. The population has now passed the 19 million mark, and is replacing itself on a natural birth basis. Immigration further increases demand pressure.

Growing internal migration also plays a role, as Australians switch from less fashionable areas to those more in demand.

For example, many people choose to retire in areas with warm climates, which is one reason for the Gold Coast's popularity. But remember, increased demand does not necessarily lead to higher prices — supply may be rising faster than demand.

Higher real incomes, the growth of single-parent households and the failure of public housing to keep pace with demand all contribute to a steady long-term upward pressure on residential prices. Add to this the traditional willingness of lenders to lend against property and it's likely that this trend will continue.

Exercise

Calculate your own House Price : Income ratio. How does it compare with the national average? If it is low, it may mean you are in a favourable position to trade up to a larger house or "free up" equity for your home for other property investments. Your objective may be to be as debt-free as possible — in which case you may want to get the ratio even lower by prepaying capital or even increasing monthly payments. Only you can consider your own situation measured against your own clear long-term goals.

Ways to Invest

There are various ways you can invest in property. The one which is right for you will depend on how much you have to invest, what type of property you want to invest in, and whether you want to become involved in the day-to-day running of the property. The main ways of getting exposure to the property market are:

- **Direct investment:** You become the sole owner of the property. For most small investors, this usually means limiting yourself to residential property.

- **Property syndicates:** A small number of investors pool their money to buy one property or a number of properties. Syndicates often have a fixed life span and the minimum investment could be as high as $500,000.

- **Unlisted Property trusts:** A large number of investors pool their money and have a professional fund manager select the properties to buy and take care of the daily administration of the properties. The minimum investment is around $10,000. The value of a unit in an unlisted trust is closely related to the trust's net asset backing. Some trusts only invest in a particular type of property, such as CBD offices, while others only invest in particular regions, such as Canberra. To find out what type of properties a particular trust invests in, you need to read the trust's prospectus.

- **Listed property trusts:** Similar in concept to unlisted property trusts, except that the units are traded on the sharemarket. The prices of listed unit trusts depend on the number of buyers and sellers. This means that their unit price can be either greater than or less than the trust's net asset backing.

- **Property securities funds:** These are unit trusts — generally unlisted trusts — which invest in listed property trusts and property companies. They are run by professional fund managers and the minimum investment varies.

- **Diversified/balanced trusts:** Professionally managed unlisted trusts which invest in a range of assets including shares, government bonds and property. The property component varies from trust to trust.

Location, location, location

Property is always about location. So the golden rule for investors — as opposed to speculators — is to always select an area where better properties already exist. In simple terms property is most valuable where the most wealth already exists or is in the process of being created

Types of Property Title

Property can be purchased under various legal titles. The main ones are:

- Old system
- Torrens title
- Strata title
- Company title

Legal costs differ for different property titles. Old system titles are becoming rare, but they still exist.

Strata title is a form of Torrens title most commonly used for home units. The home units each have a separate certificate of title. An important consideration with the Strata titles that while you have considerable freedom to do what you want, you have to abide by the by-laws which apply to the entire property.

Company title is a form of ownership applying before Strata title legislation was passed. The important thing with company titles is that you do now own real estate. You own shares in a company which owns real estate. Statutory protections which apply to purchasers of real estate do not apply. This may limit the value of the property as an investment. Banks and other lenders often restrict the funds they will lend for the purchase of company title units.

Whatever type of title you have, it is essential that you carry out a search at the Land Titles Office in your state to establish that no party has registered a claim on the property. You can do this yourself, but it is usually safer to engage an expert in title searches.

The main difference between Old Title and Torrens Title

Torrens System was progressively introduced in Australian States and Territories from about 1860. Today, Old System and Torrens Titles co-exist although the proportion of land under Old System titles is diminishing.

The Torrens System involves registration of the boundaries and ownership of land in a register maintained by a State government authority. Conveyancing land under the Torrens System is less complicated and less risky than conveyancing Old System land.

When you buy property covered by the Old System you need to investigate the history of the title on every transaction that has ever taken place over the property. This is not necessary with Torrens title property – you can only investigate whether the current seller has legal ownership of the property.

Land may also be held under freehold or leasehold title. Freehold ownership is equivalent to absolute ownership. In leasehold ownership you lease the property from the landlord. You must obey the conditions of the lease, which will stipulate what may or may not be done in relation to the property. Most importantly, leases are only for a limited period.

Speculators and Investors

What property speculators look for

Speculators try to find run-down areas with potential for rapid improvement. These include:

• Areas adjoining already established areas where a "knock-on" effect may be created. Buyers who can't afford the best area may buy next door, creating a ripple effect. You can see this strongly around Sydney, Melbourne's inner areas and the Gold Coast hinterland.
• Locations about to get new amenities, better road of train connections, expressway links, or government-funded public amenities such as theatres, gardens or street landscaping. Sydney's near south coast on Jervis Bay and Queensland's Gold and Sunshine coasts are prime examples.
• Areas where an economic or planning blight is about to be removed. Examples could included cancellation of plans to build an expressway, or where a high- tech or white-collar employer is going to replace a "smokestack" industry. Inner urban renewal such as Sydney's Pyrmont is a prime example.

What property investors look for

• Prosperous areas. These act as magnets for population growth. People need to live where they work. Hence the high prices in Sydney and Melbourne, the buoyant economies of Brisbane and the Gold Coast and water-front land.

• Superior amenity values. Wealth attracts wealth and enables amenities to be properly maintained. Parks, shops, restaurants, hotels — all add to value. Thus areas that have always been residential — such as Elizabeth Bay, Point Piper, Toorak — will maintain better values than those with an industrial legacy such as many inner-urban suburbs.

• First-class transport and road systems. Road, rail and air links have a major influence on house prices. Australia's capital and regional cities benefit from relatively easy access to airports. Property with good access to freeways to major city centres sells at a premium.

• Heritage factors. Historical and well-preserved areas carry a premium due to their conservation and history.

• Perceived status. If an area becomes seen as "in" or "trendy" then it may become fashionable regardless of traffic congestion or lack of amenities. The presence of well-known actors, painters, business people or diplomats attracts buyers and investors regardless.

• Education, shopping and security. Good schools and shopping facilities are traditional high priorities for buyers. Increasing crime in recent years now makes the local crime rate a factor to consider.

Zeroing in from "the big picture" to specifics: How to judge the potential of an individual property.

Let's take a look at the main criteria used to make purchasing decisions by the two main types of property buyer: the investor and the speculator.

Investing in property involves:

- Always taking into account the balance you need between income and capital growth.
- Choosing only those properties where you can determine the level of risk.
- Understanding the effects of current supply and demand on property — and not acting on guesses about the future.

Speculating in property may involve:

- Buying land on which you hope to get planning approval to change the use, thereby increasing the value.
- During a boom market, buying a new property at a fixed price "off the plan" and then agreeing to delay completion of contracts in the hope that its value will have risen by the time you make the final payment.
- Buying in a run-down location which you believe is about to become the next "trendy" area.

How to judge the potential of an individual property

Investing in property is a relatively safe activity, but it can easily become speculation, which is highly risky.

The following lists help you to identify the border-line. **Investing** in property involves:

- Assessing your preferred balance between investment for income and investment for capital growth.
- Choosing only those properties where you can determine the level of risk.
- Understanding the effects of current supply and demand on property – and not acting on guesses about the future.

Speculating in property may involve:

- Buying land on which you hope to get planning permission to change the use, thereby increasing the value.
- During a boom market, buying a new property at a fixed price "off the drawing board" and then agreeing to delay completion of contracts in the hope that the value will have risen by the time you make the final payment.
- Buying in a run-down location which you believe is about to become the next "trendy" area.

Property is always about location. So the golden rule for investors – as opposed to speculators – is always to select an area where better properties already exist. In simple terms property is most valuable where the most wealth already exists or is in the process of being created.

Exercise

If you are considering a future property investment, ask yourself whether you are an investor or speculator. Check your objectives with the characteristics of each of these types of property buyer and make sure you are clear as to which one you are.

What are the six main ways of investing in property? Choose one and list advantages and disadvantages of using this way to invest.

Your Home

A house is a home – but it may be a good investment too. The reasons for this are:

- You don't normally pay Capital Gains Tax on its increased value when you sell.

- You can benefit from lower interest rates, as home loan rates are usually lower than property investment rates.

- The property may be used as collateral for other investments, such as shares.

- Your house has scarcity value. In most areas of Australia there are shortages of quality building land. This may continue to make your home increasingly valuable as time goes on.

Making your property even more valuable. In general, it will pay you to enhance your property. But bear two points in mind:

- Be careful of spending money on home improvements or renovations that don't add to the value of the property. Suppose you bought a property in a relatively unfashionable area for $100,000 and spent $150,000 on renovations. It is unlikely would recoup these renovation costs immediately. The property's intrinsic value will always be linked to its location. There is a limit to what any house will sell for in a particular area. Spending too much money on a property in a poor location is called "overcapitalising".

- What actually adds value to a property varies from house to house and suburb to suburb. There are areas where it pays to convert a garage into an extra room, or add a swimming pool. But in some instances flashy improvements may make a house difficult to sell. Like attracts like, and enlarging a property into a five-bedroom home in an area which is attractive to single professionals or childless couples may make no sense. Quality fitted kitchens and bathrooms are a near universal attraction, but spending excessively on your own highly personal taste could prove a poor investment.

Always remember that one way to research the value of your property is to put it up for sale, using a "no sale, no fee" arrangement with your agent. You can then monitor the response from prospective buyers.

The costs of buying and selling a home

A part from the price of the property you must take additional costs into account. If you borrow money you will have to pay interest on the loan. Buy you might also have to pay a loan application fee, valuation fees, settlement fees and stamp duty and registration feeds on the mortgage itself and your solicitor's fees.

By far the greatest charge is stamp duty. This varies from state to state and is usually related to the price of the property – it can run to tens of thousands of dollars.

Recently-built properties may have faults

Many investors believe that the newer the property the less likely it is to have serious design or structural faults. You should never assume this is the case. The few hundred dollars you pay for a building inspection could save you from spending several hundred thousand dollars on a defective property. The same applies to recent renovations – particularly if they were done by the existing owner.

A competent building consultant should be able to detect incomplete or defective work.

You should also check that any renovations have been approved and inspected by the local council.

If you buy a recently-built property it is wise to obtain the builder's licence number and defects liability period.

How to gear up on the increased value in your home. One approach that has paid off for many homeowners is to move from home to home, adopting higher gearing each time — reducing the ratio of equity to mortgage borrowing.

Let's look at an extreme example of this:

You buy a $100,000 home with a cash deposit of $20,000. The ratio of equity to mortgage (or cash to borrowing) is 1:4. You then sell the property when it appreciates to a value of $180,000, making a tax-free profit of $80,000. You then buy a home worth $300,000, taking out a mortgage of $200,000. The equity to mortgage borrowing ratio is then 1:2. This process can be continued so that you buy a property worth say, $600,000 with profits from the capital appreciation made on the two homes you owned before.

Remember, these figures are oversimplified. They do not take into account the costs of buying and selling property and the costs of servicing the mortgage. You must also earn enough money to make the mortgage payments. But it does demonstrate one approach used by many investors to capitalise on the tax-free status of their own home.

Obviously these tactics work best when property prices are booming. It's wise to keep a capital reserve to fund your mortgage if your income is reduced, for example through redundancy. Forced sales can be a painful and costly experience.

Using Equity in Your Home

Another way to use the growing equity in your property is to extract the equity and use it to invest in another property. Your aim will be to generate rental income as well as capital appreciation from the property.

Let's see how this might work:

Suppose you bought a $100,000 property with a $70,000 mortgage. Assume this house appreciated to $140,000. You can re-mortgage the house for $120,000 in place of the original $70,000 mortgage. The $50,000 equity extracted will provide you with enough collateral to take out another mortgage of $150,000 on a $200,000 property. This second property may produce a 10 per cent annual return ($20,000 rental income). For the first few years you may actually make a loss when all other costs are taken into consideration. These other outgoings include the costs of servicing the mortgage, renovation, insurance, maintenance, and management fees.

Remember, though, that rents are rarely static. As they increase with inflation and market demand your rental income will increase. The income from the property will grow to cover expenditure. Eventually the property will become self- financing. You may even be able to re-mortgage and extract a portion of your capital gain on the second property to put down on yet another property.

High population growth does not guarantee rising property prices

An important rule with property investment is not to confuse population growth with rising property values. One simply does not lead to the other. The crucial ingredient is scarcity of available properties combined with population growth.

If there is an abundance of available land, minimal zoning restrictions and comparative affordability of houses and land for owner-occupiers, there could be potential for substantial over-supply. And this has a depressing effect on property prices.

Whether property prices go up or down depends on the combination of demand and supply factors. Concentrating on demand or supply in isolation can lead to poor investment decisions.

In these exercises it is prudent to allow for vacancy periods of between two and four weeks a year, depending on the type of property and its location.

Negative gearing will multiply your losses if property prices fall.

How you can use gearing to get high returns. The rental property investment example you have just read is based on a gross yield of 10 per cent. But to be more cautious, assume a gross yield of around five per cent.

Where to invest in residential property for letting.
The strongest and least variable demand for rental accommodation is in Australia's major cities. Their strong economies attract a large, transient population. Suburbs with universities are also attractive. You may find you can deal directly with the institutions who will recommend suitable students and staff looking for accommodation.

Towns with large employers, such as resource-processing areas like Wollongong, Newcastle, Yallourn and Gladstone, are also attractive to itinerant workers. Deals can be done with the major employers to the extent that they may agree to manage and supervise the properties or take long-term leases. This is a guaranteed source of income. High-tech areas, such as the Norwest industrial area in Sydney, and similar centres in other cities attract employees, and employers could be interested in making accommodation part of the package to retain quality staff.

Of course, there is a danger that if the industry in your area suffers a major downturn, the value of your property will drop as will the number of potential renters.

Compounding and gearing

Now you can see that by combining the effects of compounding and gearing, the increased rental stream becomes quite startling.

These individually powerful techniques don't only work in combination. The property you buy opens up many further opportunities to use the same funds several times over. This increases the effect of compounding in both magnitude and speed. The initial investment could have been raised against the security of your existing home.

In this case you'd have no need to contribute any of the initial capital outlay in cash, but you must be aware that your repayments would be higher to service the higher debt level.

For an investment property these payments are tax- deductible when the mortgage is on the investment property.

Managing your investment. You can either manage the properties yourself or appoint a manager. This will usually be an estate agent with management expertise. The manager selects and removes tenants, collects rent, attends to services, oversees maintenance and deals with complaints. Management fees are tax-deductible. Always ensure you're convinced the manager is competent. He or she must be

concerned primarily with making sure your rental income is regular and your property is properly maintained. Let's look now at an example of the economics of a typical rental investment

Rental investment – an example — Based on a two-bedroom unit costing $300,000.

Income
Gross rent $300 per week $15,600
Investment costs
Property purchase 300,000
Stamp duty* 10,000
Legal fees 3,000
Total $313,000
Running costs
Management fee — 7% of $15,600 1,092
Lease and stamp duty 50
Rates 800
Body corporate 2,600
Insurance 200
Maintenance 1,000
Total running costs $5,742

*** Stamp duty varies from state to state**

Annual surplus of income over expenditure (excluding interest charges on loans) equals $9,858 ($15,600 — $5,742). If interest charges were 13.0%, this profit would be able to service a loan of $75,831 and your net investment (including purchasing costs) would have been $133,169.

Don't forget your borrowings can be higher to negatively gear the property and get a tax deduction for the difference between income and outgoings. Most property investors take out "interest-only" loans to maximise their tax deductions.

Annual surplus of income over expenditure (excluding interest charges on loans) equals $9,858 ($15,600 — $5,742). If interest charges were 13.0%, this profit would be able to service a loan of $75,831 and your net investment (including purchasing costs) would have been $133,169.

Don't forget your borrowings can be higher to negatively gear the property and get a tax deduction for the difference between income and outgoings. Most property investors take out "interest-only" loans to maximise their tax deductions.

Exercise

Make a list of home renovations that you feel might add value to your home, given the type of neighbourhood in which you live and the features which appear to have maximum sales appeal in your locality.

Calculate your level of gearing. Consider your own "comfort zone" in relation to this gearing and whether gearing up or down, as the case may be, might better fit your own goals and objectives.

Commercial and Industrial

This category is dominated by property companies and other large institutional investors. But at the lower priced end of the market, there is room for the smaller investor to enjoy secure, reasonable yields.

Commercial property should appeal to as wide a variety of tenants as possible

What you should look for in commercial and industrial properties. As an investor in commercial and industrial property, set up your criteria for investment based on:

- Location: Always the key factor in the investment decision. Offices should be in or near the central business district or other commercial centre. Over time this may be less important as information technology allows companies to move away from major business areas. Lower standard properties may be easily let, although they may lack amenities, simply because of their desirable location.

- Design: Appearance, functional space and the costs of occupying the building are important factors. Generally, the building should be modern or recently modernised if you're expecting maximum rent.

- Tenure: Freehold tenure is more desirable than leasehold. Your improvement is permanent and the value of improvements will not revert to the lessor in the future.

- Tenancy: Choosing a suitable tenant is a key decision. The lessee should be as reliable as possible. Scrutinise the trading record of a company as a matter of course. The lessee should preferably be a well-established company. Recent commercial lease amendments make it sensible to have a lease drawn up by a solicitor.

Ask for references and ask your solicitor or accountant to assist if you are doubtful about any tenant. Consider asking for personal guarantees from all directors.

How the "secondary" market may provide good investment values. "Prime" industrial or commercial properties are located in the best positions, are new, well designed, freehold, and let to sound tenants on modern, well-drafted leases. The "secondary" market consists of properties that do not make this primary classification. These are sometimes referred to as "fringe" properties. They may still represent sound investments and be more easily affordable by an individual investor. So it's most likely that you'll be interested in this secondary classification.

Remember that when you invest in commercial or industrial property you will be looking at the total return over time as much as the present income stream. If you buy a property which has a five-year rent review clause in the lease, you may have to wait until the next review to obtain the full market rent for the property. Income will be fixed until the next rent review, but the capital value usually continues to move upwards in the expectation of higher rental income after the review. Most tenancies in Australia today have CPI reviews every 12 – 24 months.

With commercial and industrial property there is one major disadvantage. Often, you cannot immediately get the rent the property is worth. You may have to absorb the costs of waiting.

Why low yield properties may be a good investment. You might assume that properties with the highest yields are the most popular in investment terms. Closer investigation often shows that this may not be true. When yields remain low they reflect the popularity of a particular property and location. More importantly, they signify a property's capital and rental income growth potential.

Take a closer look at this. If a property is in high demand because it is expected to show above-average growth of rental income, the price of the property will rise. But the present rental income stream is static due to the rent review structure. As the price goes up and returns from rental income are static, the initial yield is low. So the most sought after properties are the ones with the lowest initial yield. Properties with the highest initial yields may be relatively poor investments in terms of ultimate potential, functional value or lease terms.

Flexibility is an advantage

Beware of purpose-built industrial properties, the use of which is restricted to existing tenants.

Always choose a building which is flexible enough to be re-let immediately to a variety of potential types of tenant if a tenant drops out.

Finally, remember that property may prove illiquid — difficult to sell when you want to. And buying and selling costs may be high.

Traditionally shop yields are lower than office yields. This reflects the fact that shop capital values have been rising in response to retailers' demand for prime central business district locations influenced by increased consumer spending power.

Commercial and industrial property risk factors. This sector includes shops, offices, warehouses and factories. It offers higher rewards at higher risk. Unlike shares which can be bought and sold rapidly, you're not likely to find a buyer for a warehouse in a hurry. But they are less prone to price volatility and potential losses. These are tangible and durable assets.

Property values and rental income are not as dependent on management ability as many other forms of investment. If a tenant goes bankrupt you may suffer only a relatively minor loss. Rents are normally paid in advance and usually paid promptly by corporate tenants. But, thorough tenant checking is always a good idea.

Economic booms and slumps dictate commercial space demand but the market may also be affected by the changing whims of retailer fashions, technological breakthroughs and the business fortunes of the individual firms who pay rent. Today's good centrally-located shop investment may be greatly reduced in value after tomorrow's competing out-of-town shopping centre opens.

So compared to a residential property, there is a greater danger of oversupply, leading to static rents or extended vacancies. A good example of this happening was in the early 1990s, when there was considerable oversupply of commercial properties caused by a building boom and the economic recession.

High returns usually mean high risks

Many investors in commercial property have achieved a 20 to 25 per cent return on their investment from income and capital growth, if they are astute enough to buy at the right time and in the right area. But be aware —just as in the share-market - high risks go hand with high returns

Your competitor in the investment market could be a large institution wanting a "safe home" for its pension funds. The institution may well be prepared to take a 10, 20 or 30 year view. It can live with a low yield for much longer than you, especially if you have to "gear up" to invest.

Remember too that commercial properties may suffer rapid depreciation if competing property owners produce a building which is more modern and flexible, and more attractive to tenants.

Commercial property, despite its drawbacks, can be a first-class investment – but it is essential to get your timing right. The recent slump in the commercial property market indicates that losses can be substantial. Because tenants are locked-in until their lease expires (although meanwhile they usually have the option to assign) you normally enjoy strong cash flow security.

Recessions may put commercial property on the sidelines for a time. But it has always managed to bounce back. Even large investors who turn to shares for higher yields invariably include at least some property in their portfolio for inflation-proof growth.

What to look for when buying a leased property
Apart from location, value is largely dictated by the physical condition of the property and the "legal quality" of the lease.

The key factors are:

- Length of lease remaining and rent review provisions
- Who bears responsibility for repairs
- The status of the tenant

Rent reviews and capital values. When you invest in commercial property which is let, you will be looking for benefits when the lease expires as well as the current income produced.

Say you buy a property which is let for ten years with a three-year rent review, you will have to wait until the next rent review to obtain the full market rent for the property.

Why you need professional advice

You will always need professional help in buying commercial property. Agents, valuers and solicitors can protect you from the often complex provisions of leases which may dramatically affect returns from your investment. Your advisers can also help in vetting potential tenants.

Income is fixed until the next review, but the capital value should continue to move upwards in expectation of higher income after the rent review.

Except for old leases, most leases are written with two to three-year reviews to market, or Consumer Price Index (CPI) reviews.

Leases must specify the method of rent review – CPI or market – nominated in advance.

Usually, rent cannot be reduced. Outgoings will be chargeable only in proportion to the relative floor space occupied by each tenant. There must be full disclosure on tenancy mix and other matters affecting the tenancy.

Leisure and Tourism

Capital gains may be high. But the chances are they will come from successful use of the property rather than its intrinsic value. Leisure properties are in general specialised, and the number of alternative uses is limited. So the investment may be high risk.

While location factors are of obvious importance, don't forget that the entrepreneurial qualities of the tenant or operator are the key influence on the enterprise's success and future property value.

Remember that restaurants fail more often than other comparable businesses. You need higher yields to compensate for increased risks.

Investing in farm land. Investing in agricultural land is more likely to pay off when farm incomes are growing rapidly, leisure demand is high and the residential property market is strong. When economic growth is poor or in recession you may have to wait a long time for significant capital gains.

Investing in vacant land. There is usually no income from vacant land, unless you get planning consent for uses such as market gardening, car parking, temporary storage or stock agistment. You still must pay rates and other outgoings, which may not be tax-deductible if there is no income from the property.

Appreciation in value and security factors are your real investment attractions. Land values, except agricultural, moved up substantially in all regions during the l980s boom, but the market has been stagnant since then.

One approach to exploiting vacant land is for personal investors to pool their properties together to be sold off as single development packages to developers. This type of pooling can be difficult to achieve.

For the smaller investor, there is great potential in acquiring adjoining properties and looking for a developer so you can sell at what is called the "marriage value" of the properties, or have the properties re-zoned for higher density development.

Building land prices follow house price movements. Aim to invest when house prices are near their trough, and sell when the house price:income ratio is nearing an historic high.

Checklist of the pros and cons of different property investments

Sector	Pros	Cons
Domestic Residential (primary residence)	• Low entry cost • Easy access to mortgages • Useful collateral for further loans • Average 10% gains and higher for prime	• Property has restricted use • No rental income unless wholly or partially vacated by investor
Residential for investment	• High capital growth potential, especially in cities • Excellent way to build assets • Market generally in landlords' favour	• Management expertise needed • Legal and planning constraints • Liability for Capital Gains Tax
Commercial property	• Capital growth • Good income stream if favoured location • Easy access to mortgages	• High entry price • Requires help from professionals • Higher risk on vacancies and legal problems
Rural	• Modest capital growth but big gains during good seasons • Use change — can bring big profits	• Low income. If rented out yields modest • Self management difficult unless small holding
Leisure property	• Capital growth • Easy access to finance • Usually strong cash flow to service borrowings	• Management content high • Entry price high for quality • Relatively high risk
Industrial	• Good returns in city and specialised areas • High yields • Capital growth strong when economy booms	• High risk with poor locations

Other Property Investments

Investing In Property Company Shares

If you don't feel comfortable investing directly in property, then shares in listed property companies, listed property trusts and unlisted property trusts are alternatives.

Property companies invest directly in property, plus they can earn income from property developments and acting as property managers.

Property company shares give you a wide choice of investments. They are valued by a combination of income and asset considerations.

Generally, listed property companies, such as Lend Lease and Mirvac, tend to concentrate on building and developing activities — they are not usually long-term property owners.

In contrast, property trusts are property owners, rather than builders and developers. Consequently, the share prices of companies involved in developing and trading properties are likely to be more volatile because they ride the swings in the property market.

Before you invest in property trusts or property company shares, read their latest annual report and look at the types of properties they own. Ask yourself the question: "If I had enough money would I buy these properties?" If the answer is no, then they are not appropriate for you.

Tax pitfalls and how to avoid them

You can often avoid or substantially reduce tax by careful planning before you make your moves. Professional advice is essential as you may unwittingly create unnecessary tax liabilities.

Tax on rents paid to you. Generally, you will be liable for tax on the rental income during the tax year less allowable expenses such as maintenance, management fees, interest and insurance costs.

When claiming tax deductions for maintenance, you must be careful to charge only non-capital items. In essence, with repairs and maintenance you should replace like with like. For example, you couldn't claim the full cost for a copper guttering if what was being replaced was steel. The copper replacement would be regarded as a capital item. This can be a complex area and it is wise to get professional advice.

If your property is negatively geared – ie. your rental income is less than your outgoings – the loss you make is tax-deductible against income from other sources, such as your salary.

Capital Gains Tax. If you buy a property as an investment with the intention of obtaining income from letting, profit on the eventual sale will be liable to Capital Gains Tax (CGT). This gain will be reduced by improvement costs and the legal and other expenses of buying and selling the property.

Keep records of every transaction. Proof of dates and types of expenditure are critical if you are to get maximum indexation benefits to reduce your tax liability. Wherever possible, you should have records of pre-September 1985 acquisitions, just in case you are questioned by the ATO.

In calculating tax payable – at your top marginal rate – it is necessary to know the "cost base" of the asset to determine the indexed cost base.

The indexed cost base takes account of changes in the CPI from the quarter in which the exchange, or purchase, took place to the quarter when the property was sold.

With real property purchases there are many more considerations, particularly if there are capital improvements at various stages during ownership after 20 September 1985 and acquisition costs. Disposal costs are also included.

It is critical, however, that you keep proper records of all your transactions – including unit certificates and share numbers if you are investing in unit trusts or property companies.

Mortgage Insurance. Increasingly, banks require personal guarantees from directors which cancel out the advantages of investing in property through a company. Directors who have been forced by their company's bankers to guarantee repayment of borrowings have lost many of the benefits of limited liability if the company becomes insolvent.

In such cases, a partnership may be an attractive alternative, even though the partners are still personally liable. This is particularly relevant if the individuals involved are high income earners. They can stream their income into the property partnership and get negatively geared tax advantages on any of the property losses.

But the best way to avoid the personal guarantee situation is to buy mortgage insurance as part of the borrowing process. If the partnership becomes insolvent and property has to be sold the mortgage insurance will cover the difference between the selling price and the funds owed.

Exercise

Research the "primary" and "secondary" industrial/commercial property areas near you and see if you can identify any low yield investment opportunities.

Write directly to 2 or 3 'property trust' or property 'share' companies and ask for information and prospectuses. Research the yields and track records of each company over the past 10 years before making an evaluation on which of these would be the investment you would choose.

final reflections

What key points have you learnt from this module?

Watch for raw land when you drive in your area and consider its potential according to the criteria listed in this lesson.

REMEMBER: Also get good tax advice from a qualified adviser before making any property investment. Your own tax position and the tax-efficiency of a specific investment may be the deciding factors in determining whether a particular property investment is right for you. Money spent on tax advice before you invest is invariably money well spent.

You are ready for the next module.